STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	)	
	)	
Annual formula rate update and revenue	)	**Docket No. 13-0318**
requirement reconciliation authorized by	)	
Section 16-108.5 of the Public Utilities Act	)	

DIRECT TESTIMONY OF DAVID J. EFFRON
ON BEHALF OF
THE PEOPLE OF THE STATE OF ILLINOIS

AG Exhibit 2.0

JULY 19, 2013

ILLINOIS COMMERCE COMMISSION DOCKET NO. 13-0318
DIRECT TESTIMONY OF DAVID J. EFFRON
TABLE OF CONTENTS

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over thirty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings and other utility matters?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over three hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University.

II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the People of the State of Illinois as represented by the Illinois Attorney General (“AG”).

Q. What is the purpose of your testimony?

A. I address certain issues related to the rate base used by Commonwealth Edison Company ("ComEd" or "the Company") in the development of its formula rates to be in effect January 1, 2014, pursuant to Section 16-108.5 of the Public Utilities Act. In this testimony, I present adjustments to the Company's position that I have identified in my review and analysis of the Company’s testimony and supporting exhibits. I also address an adjustment to the billing determinants used by the Company to calculate the rates necessary to produce the net revenue requirement, the Return on Equity (“ROE”) Collar Computation, and the method of calculating of interest on reconciliation adjustments.

III. RATE BASE

Q. Has the Company included accrued vacation pay in the operating reserves that are deducted from plant in service in the determination of rate base?

A. Yes. The Company’s calculation of the rate base deduction for accrued vacation pay is shown on ComEd Exhibit 3.02, WP 5 REV, Page 6. The Company also calculated a deferred debit related to capitalized vacation pay on that page. The deferred debit is added back to rate base on ComEd Exhibit 3.02, WP 5 REV, Page 5.

Q. Has ComEd explained what the deferred debit balance related to capitalized vacation pay represents?

A. In response to AG Data Request 3.02 in Docket No. 12-0321, the Company explained that: "Because vacation pay is charged to specific capital projects during the year in which vacation is taken, the cost of the estimated vacation pay liability expected to be distributed to capital in the following year is recorded as a deferred debit to the ComEd general ledger in FERC Account 186- Deferred Debits." The Company further explained in response to AG Data Request 3.03 in Docket No. 12-0321 that "the rate base deduction [for accrued vacation pay] should be reduced by the amount of this related deferred debit, since these deferred costs have not been recovered from ratepayers." (Docket No. 12-0321, AG/AARP Exh. 2.0, Page 4).

Q. Do you agree that the rate base deduction for accrued vacation pay should be reduced by the amount of this related deferred debit?

A. I agree that, to the extent that accrued vacation pay has not been included in operating expenses and is not included in the plant that is either in rate base or accruing AFUDC, that portion of accrued vacation pay should not be included in the operating reserves (accruals that have not yet been disbursed as cash) that are deducted from rate base. However, I disagree with the Company's treatment of the deferred debit balance related to accrued vacation pay as a separate *addition* to its rate base.

Q. Why do you disagree with the Company's treatment of adding the deferred debit balance related to accrued vacation pay to its rate base?

A. The Company adds the deferred debit to rate base on ComEd Exhibit 3.02, WP 5 REV, Page 5. However, this item does not require investor supplied funds and should not be explicitly included in the Company's rate base. Rather, this debit balance is an offset to the accrual for vacation pay, representing the portion of accrued vacation pay that is capitalized. Therefore, the debit balance should be netted against the accrued vacation pay that is included in operating reserves. This is more than merely a matter of presentation because the related deferred income taxes (which are a debit balance that is added to rate base) are calculated by applying the relevant tax rate to the accrued vacation pay included in the operating reserves.

Q. Have you calculated the effect of netting the deferred debit against the accrued vacation pay included in operating reserves, rather than making a separate addition to rate base for the deferred debit?

A. Yes. On Schedule DJE-1, I have eliminated the deferred debit from rate base and instead offset the deferred debit against the accrued vacation pay included in operating reserves. I then calculated the deferred taxes by multiplying the accrued vacation pay net of the deferred debit by the combined state and federal income tax rate of 41.175%.

Q. What is the dollar impact of your adjustment?

A. As can be seen on Schedule DJE-1, the net rate base deduction that I have calculated is $8,945,000 greater than the net rate base deduction calculated by the Company. Therefore, I recommend that the rate base used in developing the Company's formula rate revenue requirement be reduced by $8,945,000.

Q. Has the Commission previously addressed this matter?

A. Yes. AG/AARP and CUB proposed a similar adjustment to the Company's position in Docket No. 12-0321. In that case "the Commission decline[d] to make the adjustment recommended by CUB and AG/AARP" but went on to say that it "hopes to see this issue further developed in subsequent rate cases." Order at 17.

Q. Can you present an argument on this issue that is clear and concise, as encouraged by the Commission in Docket No. 13-0321?

A. I'll try. Very simply, the *net* accrued reserve for accrued vacation pay (the accrued reserve net of the capitalized portion) that is deducted from ComEd's rate base is $27,479,000. The deferred tax debit balance (representing the deferred taxes related to the accrued reserve deducted form rate base) added back to rate base should be consistent with that reserve and can be calculated by applying the combined income tax rate of 41.175% to the accrued vacation pay of $27,479,000 that is deducted from rate base.

IV. BILLING DETERMINANTS

Q. Has the Company included 2013 projected plant additions in its delivery services rate base?

A. Yes. ComEd has included $917.8 million of 2013 projected plant additions in its delivery services rate base, offset by an associated increase of $396.8 million in the balance of accumulated depreciation. The Company has also recognized an increase of

$178.9 million in the balance of accumulated deferred income taxes ("ADIT"), and a decrease of $14.9 million in the balance of construction work in progress. The net effect is to increase the Company's delivery services rate base by $327.2 million.

Q. Do the 2013 plant additions include plant related to customer growth?

A. Yes. One of the components of the total of plant additions estimated for 2013 is for "New Business." Examples are equipment and line extensions to serve new residential or commercial development. The "New Business" component of the 2013 plant in service additions, approximately $149.3 million, represents facilities to accommodate customer growth.

Q. Should the billing determinants used in the calculation of rates necessary to produce the required revenues be adjusted to reflect customer growth in 2013?

A. Yes. In past rate cases, ComEd has recognized post-test year growth in sales and revenues, consistent with its proposed inclusion of New Business plant in its adjustment for post-test year plant additions. The purpose of this adjustment was to match the billing determinants used in the determination of pro forma revenues (under both present and proposed rates) to the plant used to provide service included in rate base.

The pro forma revenues under present rates do not enter directly into the formula rate calculations presented by the Company. However, the pro forma billing determinants are used to determine the rates necessary to produce the approved net revenue requirement. I recommend that, consistent with the inclusion of New Business plant additions in 2013 in the rate base, the pro forma billing determinants related to customer count (the customer charges and the standard metering service charges) be adjusted to recognize customer growth in 2013.

Q. Why is your adjustment necessary?

A. This adjustment is necessary to properly match the billing determinants used in the determination of pro forma revenues to the plant used to provide service included in rate base.

Q. Company Witness Brinkman argues that it is inappropriate to adjust the historical weather normalized billing determinants for customer growth because the inclusion of New Business plant additions in the pro forma rate base does not ultimately affect the revenues recovered by ComEd. Do you have a response?

A. Yes. I agree that because of the reconciliation process, the inclusion of New Business plant additions in the pro forma rate base does not *ultimately* affect the revenues recovered by ComEd. However, as explained below, this does not invalidate the adjustment to billing determinants to recognize customer growth.

The Company uses the costs from 2012, plus the effect of 2013 plant additions, to establish the initial revenue requirement for 2014. The rates to produce that revenue requirement are then calculated using weather-normalized 2012 billing determinants. The initial 2014 revenue requirement will ultimately be reconciled to the actual 2014 revenue requirement based on actual 2014 costs. But there is no reconciliation of the 2012 billing determinants used to calculate the initial 2014 rates to the actual (or weather normalized) 2014 billing determinants. In substance, what the Company is advocating is that its rates be determined using the actual 2014 revenue requirement and 2012 billing determinants. At the very least, recognizing one year of reasonably expected customer growth partially mitigates this mismatch.

Q. Do you agree with Ms. Brinkman that if the Commission orders that the historical weather normalized billing determinants used to establish 2014 rates should again be adjusted, then the Commission should adjust those billing determinants both for changes in customers' use and for changes in the number of customers?

A. No. First, changes in use per customer are unrelated to New Business plant additions. Second, it is difficult to quantify actual trends in use per customer with any reasonable degree of precision. The data presented by the Company reflect the weather-normalized use per customer; but the weather-normalization process necessarily requires certain assumptions. The use of alternative (but still reasonable) assumptions could well yield differences in the calculated use per customer. The use per customer for a given time frame can also be influenced by temporary, non-recurring conditions other than weather. In fact, using the same time periods used to calculate the customer growth rates (as identified below), the use per residential customer appears to be on an *increasing* trend. However, I would not recommend that the billing determinants be adjusted to reflect increasing use per residential customer.

Q. Do you see any relevance to Ms. Brinkman's observation that the New Business plant additions account for only 0.6% of the Company's total revenue requirement?

A. No. The adjustments for customer growth have even less of an effect on the rates necessary to produce the Company's revenue requirement. That is, only 0.19% of a portion of the billing determinants of the residential class and 0.09% of a portion of the billing determinants of the commercial class are being adjusted to recognize customer growth. If customers should be unconcerned because the effect of New Business plant additions is relatively immaterial, then ComEd should be even less concerned about the adjustments to billing determinants to recognize customer growth.

Q. How are you proposing to adjust the pro forma billing determinants that are used to develop the rates necessary to produce the net revenue requirement calculated on Schedule FR A-1?

A. Using the method approved by the Commission in Docket No. 12-0321, the increase in residential customers is 0.19%, and the increase in small commercial and industrial customers is 0.09%. In designing the rates to produce the approved revenue requirement, I recommend that the billing determinants used to set rates reflect a 0.19% increase in the number of residential bills and an 0.09% increase in the number of small commercial and industrial bills, in order to reflect estimated annual growth in the number of customers in those classes and to be consistent with the inclusion of 2013 New Business plant additions in rate base.

V. ACTUAL RATE BASE TO BE USED IN COLLAR CALCULATION

Q. Has the Company presented its calculation of the earned return on equity ("ROE") in 2012 for the purpose of quantifying the ROE collar adjustment?

A. Yes. Schedule FR A-3 shows the Company's ROE collar computation.

Q. Should the Company's method of calculating the actual earned ROE for the reconciliation year be modified?

A. Yes. The Company is proposing to use the rate base as of the end of the reconciliation year for the purpose of calculating the DS Common Equity Balance and fixed cost capital balances. That is, the Company uses the actual rate base as of December 31, 2012, based on the 2012 FERC Form 1 to quantify the balance of common equity used in the ROE computation and the interest and preferred dividends used in the quantification of the net income available for common equity. Rather than the end-of-year rate base, the average rate base for the year should be used in the calculation of the earned ROE for the purpose of the collar calculation.

Q. Why should the average rate base for the year be used in the calculation of the earned ROE?

A. Very simply, applying the common equity ratio to the average rate base will produce a dollar balance that correctly represents the actual capital supplied by equity investors to support the Company's rate base over the course of the year for which the ROE is being calculated. The net income used in the ROE calculation is the income earned over the course of the year, not the annualized net income being earned at the end of the year.

To be consistent, the common equity balance used in the denominator of the ROE calculation should be the average balance of common equity over the course of the year. In times when the common equity balance is growing, using the end of period balance of common equity will understate the actual ROE earned on common equity provided by investors over the course of the year, and in times when the common equity balance is decreasing, using the end of period balance of common equity will overstate the actual ROE earned on common equity provided by investors over the course of the year.

Q. Why are you raising this issue at this time?

A. In the last legislative session, the General Assembly passed Senate Bill 9 ("SB 9") (enacted as Public Act 098-0015), which amended Section 16-108.5 of the Public Utilities Act. SB9 requires that the year-end rate base be used for the purpose of calculating the actual revenue requirement for the reconciliation year. Prior to the passage of SB 9, the Commission used the average rate base for the purpose of calculating both the reconciliation adjustment and the collar adjustment. Thus, the reconciliation adjustment accurately measured actual revenue requirement based on the average rate base for the reconciliation period. Notwithstanding the new requirement to use the year-end rate base in the reconciliation adjustment, the continuing use of the average rate base in the ROE collar calculation is necessary to accurately measure the ROE earned based on the actual equity investment over the course of the year.

Q. Can you illustrate by means of a simple example how use of the end of year common equity balance understates the actual earned return on equity when the common equity balance is growing over the course of the year?

A. Yes. Assume an investor opened a savings account at the beginning of the year and funded that account by contributing $100 per month over the course of the year. Assume further that the stated rate of interest on that account is 5%. At the end of the year, the investor will have contributed $1,200 to the account. However, he will have no claim to interest of $60, or 5% * $1,200. Rather, the interest earned would be $30, or 5% * $600, the average balance of the amount contributed for the year. If one calculated the effective interest rate by dividing $30 by $1,200, the result would be 2.5%. This obviously understates the effective interest rate actually earned by the investor. The same principle applies to the calculation of the earned ROE. If the earned ROE is calculated by dividing the net income by end of year equity balance over the course of a year when the equity investment is growing, the earned ROE will be understated.

Q. How should the rate base used in the ROE collar computation be modified?

A. On Schedule FR A-3, Line 1, the Company uses the rate base from Schedule FR A-1-REC, Line 12 (the reconciliation year-end rate base) in the ROE collar computation. The simplest modification to incorporate the average rate base into the ROE collar computation would be to include the average of the rate base on Schedule FR B-1, Line 28 in the current year filing and the approved rate base on Schedule FR B-1, Line 28 in the prior year filing on Line 1 of Schedule FR A-3. Thus, the rate base used in the calculation of the 2012 ROE collar computation would be the average of the rate base on Schedule FR B-1, Line 28 in the present filing (the rate base as of December 31, 2012) and the rate base on Schedule FR B-1, Line 28 as of December 31, 2011 as approved by the Commission.

Q. What was ComEd's average rate base and earned ROE for 2012?

A. The Commission approved a 2011 year-end rate base before projected plant additions of $6,025,672,000 in ComEd's last formula rate Order (ICC Docket 12-0321). ComEd reported a 2012 year-end rate base of $6,390,272,000 on Schedule FR A-1 REC, which is reduced to $6,381,327,000 after my proposed adjustments. The average rate base for 2012 is $6,203,500,000. The ROE resulting from this calculation is 9.75% (AG Exh. 2.1, Sch. FR A-3-DJE). The ROE collar adjustment on Schedule FR A-1 is $(25,308,000) (AG Exh. 2.1, Sch DJE-3) as compared to the Company's ROE collar adjustment of $(6,395,000), with the amounts in parentheses signifying earnings in excess of the collar's range. Thus, this adjustment results in a reduction to the Net Revenue Requirement on Line 36 of Schedule FR A-1 of $18,913,000, exclusive of any interest.

VI. CALCULATION OF INTEREST ON RECONCILIATION ADJUSTMENTS

Q. How does the Company calculate interest on the reconciliation adjustment?

A. As can be seen on Schedule FR A-4, the Company calculates interest by applying the weighted average cost of capital to the monthly balance of the reconciliation adjustment.

Q. Are you proposing to modify the method of calculating interest on reconciliation adjustments?

A. Yes. The interest should be calculated on the reconciliation adjustment, net of applicable deferred income taxes.

Q. Why are you proposing this modification?

A. Carrying charges should be calculated on the net cash investment in the deferrals when the reconciliation adjustment is a debit balance (or on the net source of funds provided by the over-recovery when the reconciliation is a credit balance). If a particular cost is deductible for income tax purposes as incurred, then the net cash investment to fund the deferred recovery of such a cost is reduced by the income tax savings associated with the tax deduction, and the carrying costs should reflect this reduction to the net cash requirement. For example, if a cost of $1,000 is deferred for future recovery from customers but that cost is deductible for income tax purposes as incurred and the combined state and federal income tax rate is 40%, then the cost will reduce income tax expense by $400 (40% * $1,000). The net cash to carry the deferral is $600 ($1,000 - $400), and only this net balance should serve as the basis on which carrying costs are accrued. The same logic applies when the reconciliation adjustment represents a credit balance owed to customers.

Q. Has the Commission previously addressed this issue?

A. Yes. In Docket No. 11-0721, ComEd's first formula rate filing, the Commission declined to offset deferred taxes against the reconciliation balance on which interest is calculated, finding that "ComEd contends that this recommendation does not provide ComEd with cash. AG/AARP provide little information establishing that this procedure is within generally accepted accounting procedures, or that it would be of benefit to ComEd or to ratepayers." Order, at 167.

Q. Do deferred taxes on the reconciliation balance represent actual cash to the utility when the reconciliation is a debit balance?

A. Yes. To the extent that the reconciliation represents an under-recovery, the current income tax expense is lower than it would have been in the absence of the under-recovery. The relevant income taxes are not actually paid until the reconciliation balance is recovered. The deferral in the payment of income taxes is a real cash benefit and should be recognized in the calculation of interest on the reconciliation balances.

Q. Is offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued within generally accepted accounting procedures?

A. Mr. Brosch addresses generally accepted accounting procedures applicable to this issue. I can state that calculating the interest on the net cash investment (or net source of funds) is most definitely consistent with all ratemaking principles with which I am familiar and certainly does not violate any generally accepted accounting procedures.

I would further note that the Company itself records deferred taxes on the regulatory asset associated with the under-recovery of its revenue requirements (response to AG Data Request 1.04). The existence of these deferred taxes must be recognized, and the appropriate method to do so is to offset the applicable deferred income taxes against the regulatory asset (or regulatory liability) related to the reconciliation balance on which interest is calculated.

Q. Would offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued be of benefit to the utility?

A. When the reconciliation balance is a credit balance, offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued is of benefit to the utility, because the utility is then required to credit customers for interest on only the net source of funds provided by the over-recovery.

Q. Would offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued be of benefit to ratepayers?

A. When the reconciliation balance is a debit balance, offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued is of benefit to ratepayers, because the utility then recovers interest on only the net use of funds required by the under-recovery.

Offsetting the deferred taxes against the reconciliation balance when calculating interest avoids crediting interest on funds that the utility is not holding or recovering interest on an investment that it does not have. In this regard, it is fair to both the utility and ratepayers.

Q. Has anything changed since the formula rate applications previously filed by the utilities that increases the significance of this issue?

A. Yes. Previously, the Commission had ordered the use of the short-term debt rate in calculating the interest on reconciliation adjustments. Because the short-term debt rate has recently been so low, the interest accrued on reconciliation adjustments was relatively immaterial, and the difference between the interest on the pre-tax reconciliation adjustment and the after-tax reconciliation adjustment was relatively negligible. However, since the passage of SB9, the utilities are required to use the weighted average cost of capital in calculating interest on the reconciliation adjustments. Because the weighted average cost of capital is so much higher than the interest rate on short-term debt, the interest on the reconciliation adjustment is no longer immaterial. The Commission should ensure that the interest either credited to customers or recovered from customers is limited to the interest on the net source or use of funds related to the reconciliation adjustment.

Q. Does this conclude your direct testimony?

A. Yes.